ORIGINAL

0000124301

Michael J. LaVelle – State Bar No. 002296
Matthew K. LaVelle – State Bar No. 018828
LAVELLE & LAVELLE, PLC
2525 East Camelback Road, Suite 888
Phoenix, AZ 85016
MJL@LaVelle-LaVelle.com
Matt@LaVelle-LaVelle.com
Telephone: (602) 279-2100
Facsimile: (602) 279-2114
Attorneys for Respondents Tom Hirsch, Diane Rose Hirsch, Berta Walder, Howard Walder, Harish P. Shah, Madhavi H. Shah and Horizon Partners, LLC

BEFORE THE ARIZONA CORPORATION COMMISSION

In the matter of:

RADICAL BUNNY, L.L.C., an Arizona limited liability company,

HORIZON PARTNERS, L.L.C., an Arizona limited liability company,

TOM HIRSCH (aka TOMAS N. HIRSCH)and DIANE ROSE HIRSCH, husband and wife;

BERTA FRIEDMAN. WALDER (aka BUNNY WALDER, a married person,

HOWARD EVAN WALDER, a married person,

HARISH PANNALAL SHAH and MADHAVI H. SHAH, husband and wife,

Respondents.

DOCKET NO. S-20660A-09-0107

RESPONDENT'S POST HEARING MEMORANDUM

I. An Overview

As shown by the accompanying materials, Defendants did issue the notes in question. Defendants were members of a company that served as a buyer's agent to buy fractional interests in notes. Some were notes issued by various entities involved in construction projects (borrowers) and some were issued by Mortgages Ltd. to obtain funds to lend for construction projects. For the purpose of this Motion, those differences are irrelevant. All of the money raised was for construction, not financing for a business. The notes were commercial notes for a short-term, fixed percentage amount, were guaranteed and were not premised on someone else's profit. The participations did not result from an organized marketing or solicitation program. The crucial questions is, are such fractionalized commercial notes securities so that the Division may bring this proceeding and if so, did Defendants commit securities fraud in connection with their transfer?

The Securities Division has failed to prove fraud and it has failed to prove that what the participants received was a security.

A. The Participations Were Not "Securities."

The first program was the Horizon program which divided up loans made to third parties by Mortgages Ltd. Radical Bunny later made loans to Mortgages Ltd. as a whole, took all of the assets Mortgages Ltd. had as security for those loans and then divided those loans. *See* Exhibits S-33, S-37A, S-37B. The note in question was always issued by Mortgages Ltd. The participants signed a direction to purchase which referred to a specific RBMLTD loan. *See* Exhibits S-12E, S-12G, S-13F, S-13H. That notice was accompanied by a letter, *see* Exhibit S-12 i, Shah at p. 1122, l. 10-20, which informed the parties that Horizon Partners investments would be serviced by Radical Bunny and would be subject to servicing expense of 2%. Participants also received a higher rate of return. Nobody denied they were told that Radical Bunny would not receive a spread under the new program, but more to the point, nobody said they thought that

Radical Bunny was in charge of Mortgages Ltd.'s ability to pay. No participant thought Radical Bunny controlled Mortgages Ltd.'s investments. Radical Bunny made loans to Mortgages Ltd. and before September of 2005 received existing Mortgages Ltd. loans and divided those loans up so that participants could participate in the interest and principal return from those loans. The loans themselves were solely the responsibility of Mortgages Ltd. and were classic commercial loans. *See* for example the testimony of attorney Robert Kant, pp. 1278-1279 to the effect that the promissory notes referencing a loan or commercial transaction are not generally considered securities and flat statement of attorney Robert Bornhoft that the loans were commercial loans. (*Bornhoft at pp.652-653*). All Radical Bunny did was divide those loans. Radical Bunny was a servicer and a conduit. (*Hirsch at pp. 1583-1584*).

There is no claim by the Division that the loans from Radical Bunny to Mortgages Ltd. were securities. They were commercial notes, *(Bornhoft at pp.652-653)* and *(Robert Kant at pp.1278-1279)* Mortgages Ltd. used the money to make commercial loans to developers. *(Bornhoft at pp 652-653, Grainger at p.1955-1956, Hirsch at p. 1701)*. Apparently the Division thinks something changed the character of those loans because of what Radical Bunny did.

Radical Bunny divided those loans, but did not advertise or solicit for participants. More importantly, the Corporation Commission has never before tried to regulate the transfer and division of commercial notes. Such transfers routinely occur and long standing factors such as Maury Resnick, Tony Nicoli, Chuck Coles, retired judges, small furniture stores and car dealers have routinely been able to deal with commercial notes or fractionate them without interference by the Corporation Commission.

A finding of liability in this case would obligate the commission to expand its regulation to all of the fractionalizations of all commercial notes. It would subject the Commission and its Commissioners to liability when it failed to fund or

police the vast new area of commerce that the Division would have it claim. And there is no grant of authority for such an expansion. It would ignore well settled principals of State and Federal Securities Law to the effect that commercial paper and its distribution in fractions is beyond the scope of securities laws. *See AMFAC Mortgage Corp.* v. *Arizona Mall*, 583 F.2d 426 (9th Cir. 1978) which applied Arizona State securities law. The participations were in commercial notes issued by Mortgages Ltd., not Radical Bunny. Nothing allows this Commission to regulate them.

B. No Fraud Occurred

As developed below everyone was told there are "no guarantees" and that all investment involves risk. Words such as "safe" or "secured" do not create liability. Here it is undisputed that the participants were ultimately treated as secured and "safe" is only an opinion. Moreover "forward looking" statements which address the future cannot be the basis of a claim of fraud when the participants both were told and understood there could be "no guarantees."

II. Facts

A. History

In 1995, some of the people who ultimately became members of Radical Bunny began to invest in mortgages serviced by Mortgages Ltd. At that point, the participants invested directly in the mortgages and received a percentage interest in certain mortgages that Mortgages Ltd. serviced. *(Hirsch at pp.1510-1512)* Thus, in the beginning, and thereafter, Mortgages Ltd. found borrowers that created mortgages and sold to the participants "pass through" fractional loans and lien interest in real estate collateral. *(Hirsch at pp.1510-1512)* The Mortgages Ltd. loans were commercial loans first position deeds for the financing of construction with limits on loan to value ratios. (*Raval at pp.2012-2014, Bornhoft at pp.652-653).*

Both Horizon Partners and Radical Bunny were formed for the purpose of pooling funds to invest in Mortgages Ltd.'s pass through program. *(Hirsch at 1510-12, 1522-1523).* (*Exhibit S-56 at pp. 9-10, Hirsch Declaration at p. 2*). Horizon Partners and Radical Bunny did not advertise. They did not solicit. People satisfied with their investment returns described the program to their acquaintances and if those acquaintances choose to inquire, in some instances they became additional participants. There were no sales materials. There were no commissions paid; no referral fees, no presentations to the public. There was no website. There was no soliciting, no yellow page advertisement. *(Hirsch at pp.1609-1611).* There was not even a sign on the door where Radical Bunny was headquartered (*Hirsch at pp.1698-1699).* Participants put their money in a Radical Bunny Trust account. *(Hirsch at p.1676).* They were participating in fractional interest in loans to Mortgages Ltd. They were not investors in Radical Bunny and did not become owners or equity holders in Radical Bunny. Radical Bunny was just a servicer. *(Hirsch at pp.1671-1672, 1695).*

No money was diverted, unaccounted for, misappropriated or missing; there was no Ponzi Scheme here. *(Berta Walder at pp.1458-1459).* The participants were provided information that came from Mortgages Ltd. and later on approximately on a semi-annual basis, there was a meeting held in which matters were discussed related to the various programs. *Hirsch at pp. 1558, Howard Walder at pp. 1035-45, Exhibit S-24.*

In approximately 2000, Horizon Partners received a "spread" of one quarter of one percent. Horizon Partners made all distributions of interest and the principal to participants, maintained accounts for participants, provided regular account statements reviewed the loan summary sheets presented by Mortgages Ltd. Horizon Partners also provided tax forms at the conclusion of each tax year. (*Hoffman at pp. 762-764).*

Radical Bunny was formed in June of 1999. Mortgages Ltd. wanted $100,000 minimum investments. The new Radical Bunny program from 2005 on required $50,000 then $25,000 from each participant which were then pooled when Radical Bunny loaned to Mortgages Ltd. or earlier when Horizon transferred a particular Mortgages Ltd. loan to a group of participants. (*Berta Walder at p. 1355*). *See* Notice and answer each at ¶42. Radical Bunny was formed to overcome these hurdles for participants. From June 24, 1999 forward, Radical Bunny and Horizon both were paid an extra one quarter or one half percent of all payments to cover the overhead of pooling funds and the preparation of necessary tax and other documents. (*Berta Walder at p. 1355, Exhibit S-33, 37(a) and 37(b)*).

After September 2005, Horizon did no more business and notified the participants that the new servicer would be Radical Bunny. In 2005, Mortgages Ltd. wanted to institute a new opportunity program, by which million dollar notes would be issued by Mortgages Ltd. who would be obligated to pay the money and would lend the money to its borrowers. (*Shah at p. 1122, Exhibit S-12(i)*). In approximately 2005, Radical Bunny began to receive on new loans only a 2% spread. (*Berta Walder at p. 1355*). The participants requested Radical Bunny to act as their agent to purchase interests in specific Mortgages Ltd. loans. *See* Exhibit S-12(i). The 2% spread was repeatedly and fully disclosed to all participants and was the subject of an extensive presentation at the participants' semi-annual meeting held in 2006. Thereafter, it was discussed at every semi-annual meeting. (*Howard Walder at pp. 1035-1045, Exhibit S-12(i)*). The invitation to semi-annual meetings specifically stated that the purpose was not to solicit any new investors. *(ACC exhibit S-23(a))*.

Later, the loans were made with Mortgages Ltd. itself as the borrower. In all instances, the loans were made and the notes were given to finance construction. The proceeds could not be used for overhead. *(Hirsch at pp.1701-1703)*.

C. The Loans And The Participants Were, In Fact, Secured

The loans made to Mortgages Ltd. were secured. Mortgages Ltd. assured Radical Bunny and its participants that they were secured. Mr. Coles represented Radical Bunny was secured by all of the assets of Mortgages Ltd.

The Bankruptcy Court's plan treated Radical Bunny as a secured creditor and gave it all the relief asserted in the claim for secured status. *See* Exhibit R-4, R-5 (*Plan of Reorganization at p.21 and Order).*

Mr. Olsen, the chief financial officer of Mortgages Ltd. told a group of individual participants that Radical Bunny held as security of all the assets of Mortgages Ltd. *(Patel at pp.1932-1935, 2011-2014, Hirsch at pp.1628-1630).* Scott Coles also said Radical Bunny was secured and Mortgages Ltd. prepared the security documents including UCC-1 filings, notes, and a list of assets used for security interim financials and a balance sheet. *(Hirsch at p.1746).*

The Findings of Fact and Conclusions of Law issued by the Bankruptcy judge in the Mortgages Ltd bankruptcy *Exhibit R4-R5* found that Radical bunny was the largest creditor and the only major secured creditor of Mortgages Ltd. at the inception of the Mortgages Ltd Bankruptcy, (*Plan of Reorganization at pp.21-25 and Order)* and further recognized that it had a first priority security interest in Mortgages Ltd.'s interest in more than $94 million in one project alone. *(Plan of Reorganization at p.25)* Mortgages Ltd. prepared the documents and always represented the loans from Radical bunny to Mortgages Ltd. were secured. The audited statements of Mortgages Ltd. said all of the assets of Mortgages Ltd. were pledged to secure the Radical Bunny loans. Any defects in the paperwork did not bar the existence of secured status. Recently the bankruptcy court found the proof of claim alone constituted a prima facie case that Radical Bunny was secured. (*Findings of Fact and Conclusions of Law and amended Order Granting Radical Bunny's Administrative Claim at pp.3 and 20*) They were backed by promissory notes, financing statements, a personal guaranty of the only stockholder of

Mortgages Ltd., Scott Coles, and the constant assurances of Mortgages Ltd. officers that Radical Bunny had a secured interest in all of the assets of Mortgages Ltd. *(Hirsch at pp.1628-1630, 1691-1694, 1746, Bankruptcy findings at pp.3 ¶7).* All of the defendants believed the loans were secured *(Berta Walder at pp.1339, 1396, 1406-1408, Hirsch at pp.1544, 1556, 1567-1568, 1589)* and when the issue was finally determined in a court of law, their belief was confirmed. *(Plan of Reorganization at p.21).*

Jordan Kroop, a bankruptcy lawyer in both the Radical Bunny and Mortgages Ltd. bankruptcy cases recognized the law allows for equitable security. *(Kroop at pp.2096, 2103).* He also recognized that at the end of the Mortgages Ltd. bankruptcy Radical Bunny received, without concession, a determination it was secured, which was everything it could have won. *(Kroop at pp.2102-2103).*

Mr. Bornhoft, the lawyer who wrote a letter saying Radical Bunny was unsecured, had no opinion about whether they had equitable lien rights or that their claim of security could not be enforced. *(Bornhoft at pp.546, 640-641).*

D. Respondents Did Not Determine Whether Mortgages Ltd. Made Money

As agents and members of Radical Bunny, Defendants reviewed the Mortgages Ltd. loans that were to be funded, Defendants received internal financial statements prepared by Mortgages Ltd., had meetings with company management, received audited third party financial statements, reviewed lending criteria, inspected loan documents, met with Mortgages Ltd. borrowers, spoke to Mortgages Ltd. officers and reviewed documents with those officers. They also made site visits. *(Berta Walder at pp.1336-1337, Hirsch at pp.1570-1571).* But there is no evidence they controlled Mortgages Ltd.'s accounting or profitability.

E. Participants Acquired A Percentage Interest In Particular Loans

The participants, after they submitted their money, executed a direction to purchase. A typical direction to purchase was a confirmation of funds already

submitted, not a solicitation to become a participant in the program. The direction to purchase authorized a purchaser's agent (Radical Bunny) to acquire an interest in a specific Mortgages Ltd. loan. The direction to purchase set forth the amount submitted, the percentage interest in the Mortgages Ltd. loan that the participant would have, the annual (net interest rate) to be paid to the participant, the maturity date of the loan and interest payment due date. The direction to purchase included. "Your investment is collateralized by the beneficial interest under various deeds of trusts held by Mortgages Ltd." *See* Exhibit 12(l). Mortgages Ltd prepared all loan documents and UCC-1's which is recorded. *(Hirsch at pp.1643-1648).* None of the Defendants in this matter took a profit out of Radical Bunny. *(Hirsch at p.1580).* All money went into a trust account. Any repayment to any of the participants if they so instructed was virtually immediate, otherwise upon a participants instruction, it was reinvested in another Mortgages Ltd. loan program. *(Howard Walder at pp.1975-1978, Hirsch at pp.1694-1695).*

F. Respondents Did Not Gain

Mr. Hirsch sold a residence, an accounting practice, took a home equity advance on two of his homes and sold other property to put money into investments with Mortgages Ltd. as a participant of Radical Bunny. *(Hirsch at p. 1580).* During the time before Mr. Coles died Mr. Hirsch was shown as receiving about $1.23 million on the books but at the same time he spent $2.5 to $3 million in participations. *(Hirsch at pp.1580, 1606, 1804-1805).* Harish Shah took money out of his home equity line of credit, and his employee pension all of which went to Mortgages Ltd. as a participant of Radical Bunny. *(Hirsch Declaration at p.4).* Howard and Berta Walder rolled over individual retirement accounts, sold a house and took an advance on their home equity all to become participants. *(Hirsch Declaration at p.4).* The total amount of monies put into Mortgages Ltd. programs by these participants as Radical Bunny participants and not returned was over $7,000,000. *(Hirsch Declaration at p.4).* The participants took no money from

Horizon Investments or Radical Bunny in excess of what they put in. *(Hirsch at p.1580).*

G. The Unwritten "Securities" Opinion

In the fourth quarter in 2006, a concern was raised by Todd Brown of Mortgages Ltd. as to whether Radical Bunny was required to take some action under the Securities law. Radical Bunny interviewed a variety of lawyers. Radical Bunny eventually hired Quarles & Brady. The entire representation proceeded along the basis of what action was necessary to "fix" any problems Radical Bunny may have had. No lawyer ever told any of the Defendants to stop taking participants' money or, that they were violating securities laws or that they were operating illegally. *(Hirsch at pp.1584, 1592, Berta Walder at pp.1429-1430, 1462-1463).*

The participants only received interest and principal. They did not participate in the profit of either Mortgages Ltd. or Radical Bunny and were not responsible for any expenses or cash calls from those entities. *(Hirsch at p.1676, Berta Walder at pp. 1458-1459).* The participants never invested in Radical Bunny. The obligation to participants was from Mortgages Ltd. directly to the participants in the matters stated. *(Hirsch at pp.1701-1703).*

Those facts stymied Quarles & Brady's determination of whether the participations were "securities" for over two months. That fact alone casts serious doubt on any conclusions reached by others after a brief description of the program.

More importantly, there is not one scrap of paper beyond purported "notes" to support Quarles & Brady's belated claim that it concluded the participations were securities and told Radical Bunny to stop selling them. Mr. Shullaw who was the associate researching that matter did not write an opinion to that effect, Mr. Hoffman wrote no letter to Radical Bunny reaching a "securities" conclusion and Mr. Bornhoft, after the firm supposedly told Radical Bunny to stop doing business,

wrote a document recognizing they were still in business. Mr. Hoffman had to admit the advice, if it occurred, was "momentous" but apparently not so "momentous" that the firm ever put it in writing to Radical Bunny. *(Hoffman at pp.862, 877-880).* But even if it had, the decision is now for the Commission or ultimately the Courts. Whatever Quarles & Brady's present litigation motivation, their undocumented opinion does not decide this case. It must be decided on the law which clearly exempts commercial notes from the definition of security.

H. No Solicitation Occurred

No commission or referral fees were paid and no solicitations were ever made. There was no marketing of these participations, no sales materials were ever prepared and no sales calls were ever made. They did not have a website or a "presentation" for the purpose of raising money. They only returned calls. *(Hirsch at pp.1609-1610).* Even the Division's proposed finding of fact on this issue recognizes the clear evidence that there was no solicitation. It says,

> "From January 1998 until after June 2008, investors learned of Horizon Partners and Radical Bunny Investment opportunities from their accountant, Hirsch and Shah, or by "words of mouth" from existing investors or their friends and/or family. Investors were friends, relatives, friends of relatives, friends of friends and friends of clients."

Divisions Post Hearing Memorandum at p. 9 ¶58 citing *Mathis* at *p. 347*, *Howard Walder at pp. 1055-1058* and *Grainger at pp. 1947-1948.*

There was not even a sign on the door. No phone calls, no commission agreements, no salesmen, no flyers. *(Howard Walder at pp. 1055-1057).* No inducement other than the interest to be paid by Mortgages Ltd. was discussed. *(Sell at pp. 347-348, Howard Walder at pp. 1055-1057).*

The return did not depend on the efforts of Radical Bunny. Once the money was loaned the fixed return came from Mortgages Ltd. and participants depended only on these payments Mortgages Ltd. The participations were not described or thought of as securities. They were in all cases percentage interests in loans made to finance construction. *(Hirsch at pp.1592, 1701-1703).* Respondents swore Mr. Kant never said the way Radical Bunny was operating was illegal or that people could go to jail. (*Hirsch at p.1899*).

Mr. Bornhoft in June 2007, after all business was supposed to be halted, prepared a document that said Radical Bunny "continues to make loans to the debtor". *(Mr. Bornhoft at pp.660-661).* Radical Bunny Proof of Claim in bankruptcy, *see* Exhibit S-37(a). Defendants denied they were told to stop doing business and report past violations. *(Hirsch at pp.1792-1794, Berta Walder at pp.1429-1430).* While they did go forward with plans for a Private Offering Memorandum, it was to erase any doubt about the status of the participations. Private Offering Memorandum was equated with Peace of Mind. *(Hirsch at 99.1793-1794).*

Mr. Hirsch denies Mr. Kant said Radical Bunny was involved in illegal activities. *(Hirsch at p.1899).* Quarles & Brady only said they did not know for sure what Radical Bunny was. *(Berta Walder at pp.1385-1386, 1388-1390).* No one said a word about securities regulation in the meeting with Mr. Sell. The program at issue did not exist when Defendants talked to Mr. Sell. *(Hirsch at pp.1580-1581, 1764-1765, 1784).*

Mr. Raval, Mr. Patel and Mr. Grainger all said risks were discussed and were the subject of memos by some of those witnesses. *(Patel at p.1936, Raval at pp.1997-1998, Grainger at p.1949-1950*). Mr. Patel learned of the existence of Radical Bunny by asking Mr. Shah's wife about investments. He was not solicited by Mr. Shah. *(Mr. Patel at pp.1925-1926, 1943).* See, also Patel testimony he said Defendants did not get him involved. *(Patel at p.1943).* The members of Radical

Bunny did not say there was no risk to the investment. Berta Walder used the example of a dirty bomb to show that every investment had risks, pp.1493-1497. Radical Bunny acted as a servicer and conduit. *(Hirsch at pp.1556-1557, 1671-1674, 1818).*

C. There Was No Fraud.

The only hard evidence of the oral information provided new, unsolicited participants was a surreptitiously taped recorded statement of Steven Freidberg's conversation with Bunny Walder. The representations are a model of clarity, "none of this is guaranteed...we have a history...you have two CPA's that are licensed, still actively involved in taxes and working, but there is no guarantees. I mean there can't be. Otherwise it wouldn't be an investment..." *See* Exhibit S-14 at 44:27.

Ms. Walder also accurately said that so long as Radical Bunny did not actively solicit for investors then Radical Bunny would not be subject to Securities Laws. *(Steven Freidberg at pp. 1657-1658)* That the investment was represented as "safe" or "secured" was the only common contention of virtually all of the participants who testified for the Commission. Some disappointed participants now say they sought a completely guaranteed investment. Instead they got the truth. The only representation established was that Mortgages Ltd. had always paid on time, that the history indicated that it was a reliable investment (*Richard Freidberg at p. 69*) that Scott Coles "never lost a dollar of investors' money." (*Mathis at pp.316, l. 21-317, l. 6*). Radical Bunny never lost a single penny. Mortgages Ltd. never lost a single penny. *See* Exhibit S-14 at 15:00. Ms. Hinman testified that she invested because she was looking for "safe investment." Barbara Mathis was the same. She was told that Mr. Hirsch and Ms. Walder thought the investment safe because it was unlikely that all of Mortgages Ltd.'s loans would go bad at the same time. (*Mathis pp. 272, l. 15 to 273, l. 5*). All those factual statements are true.

No one was told there was no risk. Some of the investors admitted that they knew there is always a risk. (*Richard Freidberg at p. 107*). The surreptitious tape clearly proved Respondents never said the participations were guaranteed. Ultimately every participant did turn out to be secured and at the end of the Bankruptcy litigation Radical Bunny received a determination it was secured which was everything it could have won in further litigation about its secured status. (*Kroop at pp. 2102-2103*).

The Commission, without ever coming right out and saying it, seems to be relying on the fact that certain lawyers testified that without being hired or without any study, they made snap judgments that some sort of registration was required.

III. The Law

A. The Law Exempts These Notes From Securities Regulators.

The Securities statutes, both the Federal statutes and the State statutes, all define a security to include "any...note." But that is just the beginning of the inquiry. "The Supreme Court has often admonished that a "thing may be within the letter of the statute and yet not within the statute." *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975)." *Ruefenacht v. O'Halloran*, 737 F.2d 320 (3d. Cir. 1984). This lawsuit is based on claims of fraud in the purchase or sale of securities. If there is no security the Commission has no claim or jurisdiction. *America Bus. Line, Inc. v. Arizona Corp. Comm.*, 129 Ariz. 595, 633 P.2d 404 (1981); *Mohave Disposal Inc. v. City of Kingman*, 184 Ariz. 368, 909 Ariz. 435 (App. 1995).

In fact, while Article 15 § 4 of the Arizona Constitution gives it the power to "investigate" and inspect and thus has the power of a Court to "enforce attendance" and "the production of evidence, *see* also A.R.S. § 44-1823 to the same effect A.R.S. § 44-1822 limits even that power to people "issuing or dealing in or selling or buying securities." By participating in a review of merits, Respondents do not waive their claims that the Commission has no jurisdiction to

impose the relief the Division seeks or to address the subject of commercial notes which are subsequently divided into fractions and transferred. Nothing gives it the power to recover money in the amount of participants' losses or to levy fines related to the creation of the notes or the participations in those notes. Whatever authority it might have had disappeared when the sections dealing with the power of the Corporation Commission were removed in the 1994 revisions of the corporate code.

The Division can only impose civil penalties of $5,000 per violation, A.R.S. § 44-2037, or administrative penalties of $5,000 per violation. A.R.S. § 44-2306. No part of the evidence has specified the number of violations and the Division did not approach the case as though it required proof of the number of violations. The Commission cannot just determine the participants total losses and award that amount. No statute or constitutional provision gives it that authority. And unless a security is involved it can do nothing.

The name given to the instrument does not determine if it is a security. For instance, in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), the court considered "stock" in a cooperative. The court said "common sense suggests that people who intend to buy residential apartments in a state subsidized cooperative, for personal use are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called share of stock." *See* 421 U.S. 849. The Supreme Court held that while the cooperative shares were called stock and "stock" was specifically listed in the definition of securities, cooperative shares do not equate to something ordinarily called stock.

What Radical Bunny conveyed was participations in notes <u>not</u> issued by Radical Bunny. These notes were for a fixed return of a non-contingent obligation.

The notes issued by Mortgages, Ltd. were not premised on profit. They were for a fixed percentage. Those same notes, in fractional interests were conveyed to the Radical Bunny participants. No one in any of the related proceedings in this case has contended that these notes, as issued by Mortgages, Ltd. were anything but common variety commercial notes, fitting within the common understanding that commercial notes are not securities. That is because there is not "risk capital" involved. "The investment—commercial test is premised on the view securities laws evinced the concern of congress about practices associated with investment transactions, and that securities laws were not designed to regulate commercial transactions." *AMFAC Mortgage Co. v. Arizona Mall of Tempe, Inc.*, 583 F.2d 426, 430 (9th Cir. 1978). A holder of a fractional interest in these notes is entitled to payment regardless of the success of the venture and is not entitled to share in the profits. The test is whether the participants "contributed risk capital" subject to the "entrepreneurial or managerial efforts" of others. *United California Bank v. THC Financial Corp.*, 557 F.2d 1351, 1358 (9th Cir. 1977), *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252 (9th Cir. 1976).

The seminal case of *SEC v. J.W. Howey Co.*, 328 U.S. 293 (1946), requires that an investment contract be "an investment of money in a common enterprise with profits to come solely from the efforts of others." *See*, 328 U.S. at 301. Using that reasoning, the Court also held that employee's interest in a compulsory pension plan even though it had investments, which had a return and was clearly designed to return money, was not a "security" within the meanings of the act. *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979).

The Court noted that the employee did not invest in the pension fund, he only accepted employment. Here, the participant did not invest in Radical Bunny. Radical Bunny was the agent that acquired Mortgage Ltd. notes for its principals.

Before the law was changed to exempt certificates of deposits, *Marine Bank v. Weaver*, 455 U.S. 551 (1982), also held that such deposits were not securities. The 1934 Act specifically included the term "certificate of deposit," but the court noted that the securities laws were not intended to provide a broad remedy for all fraud.

The characteristics usually associated with securities are the right to receive dividends contingent upon a portion of the profits, negotiability, the ability to be pledged or hypothecated, the conferring of voting rights in proportion to the number of shares owned and finally the capacity to depreciate in value. *See Landreth Timber Co. v. Landreth,* 471 U.S. 631 (1985). In that case, the court reserved until another day the question of whether notes or bonds might be shown by proving only the document itself. Five years later in *Reeves v. Ernst & Young*, 494 U.S. 56 (1990), the court said "that whether a note is a security depends on the nature of the note." Here the notes were used to finance construction. No lawyer involved thought of the base notes to Mortgages Ltd. as securities. So we pass to whether Radical Bunny did anything to make commercial notes into securities within either of the Federal Securities Acts.

As shown above, notes may not be notes for securities purposes. The cases are many. *See Kansas State Bank v. Citizens Bank*, 737 F.2d 1490 (8th Cir. 1984), (participation in notes not subject to anti fraud provisions because it was collateralized, was at a fixed interest rate and the borrower intended to use the funds as operating funds). *Chemical Bank v. Arthur Anderson & Co.*, 726 F.2d 930 (2nd Cir. 1984) (notes to finance a borrowers current operations were not securities even though their maturity may have exceeded nine months).

That analysis brings us to *AMFAC Mortgage Corporation v. Arizona Mall of Tempe, Inc.*, 583 F.2d 426 (9th Cir. 1978). There the instruments were notes and suit was brought both under the Federal Securities Statutes and the Arizona Statute. The court held a motion to dismiss appropriate. After noting that "It has

been left to Federal courts to determine what financial transactions actually involve 'securities'." Id., 583 F.2d at 431, and after noting a split in the circuits as to the tests used, the court reached this conclusion: "A note given to a lender in the course of a commercial financing transaction is not a security within the meaning of Federal Securities laws." Id., 583 F.2d at 434. It finally concluded, "If we were to expand the reach of these acts to ordinary commercial loan transactions the purpose behind these laws would be distorted." Id., 583 F.2d at 434. *See also, United American Bank v. Gunter*, 620 F.2d 1008 (5th Cir. 1981), *Dubach v. Weitzel*, 135 F.3d 590 (8th Cir. 1998) and *LaBrun v. Kuswa*, 24 Supp. 2d 641 (E.D. La. 1998) holding commercial paper exempt even where the funds went into operating capital, not the case here.

AMFAC holds that the fact a loan is secured and the fact that personal guarantees were received makes the holder less dependent on "entrepreneurial efforts." A 24 month due date also was held to lessen risk. In our case, the notes were due in 12 months.

These notes were given to a lender in the course of commercial financing transactions. Under the *AMFAC* decision reviewing both State and Federal law, they were held not to be securities for the purposes of the fraud provisions of State and Federal law.

The Ninth Circuit said the following factors must be considered to determine whether an obligation is a security: (1) time, (2) collateralization, (3) form of the obligation, (4) circumstances of issuance, (5) relationship between the amount borrowed and the size of the borrower's business, and (6) the contemplated use of the funds. *AMFAC* at 431. In *AMFAC* as well as here, the notes were fractionalized and distributed. In *AMFAC* 90% was divided and distributed to various real estate investment trusts. Here the interests in the notes were divided and distributed without solicitation. That does not create a security. *See*, e.g. *De Luz Ranchos Inv., Ltd. v. Coldwell Banker & Co.*, 608 F.2d 1297 (9th

Cir.1979) (an agent who merely transferred title to land contracts is not involved with securities or investment contracts).

In Arizona for criminal purposes, a note is a note and fraud in connection with it will support a criminal charge. *State v. Tober*, 173 Ariz. 211, 841 P.2d 206 (1992). In criminal cases the court does not look at either the "risk capital" test of AMFAC, *supra*, or the "family resemblance test" of *Reves v. Ernest F. Young*, *supra*.

But under either test for regulation or civil fraud provisions, commercial paper and commercial notes are exempt. AMFAC, *supra*, *United American Bank*, *supra* and *LaBrun v. Kusevia*, *supra*. It does not matter which "test" is applied, commercial paper is a long existing, time honored inception to both State and Federal Securities laws. AMFAC did not just apply the Federal law test much discussed. It reviewed the Arizona securities laws and found that the Arizona Statutes did not apply to fractionated commercial notes. Nothing has overruled that decision and the Commission has taken no action up to now to regulate the historical trade in commercial paper, its discounting, its fractionalization, or the retention of a portion of the interest paid by parties in the sometimes lengthy stream of ownership. It is unfortunate that participants may have sustained losses (the final results in the Bankruptcies are not in) but the Commission is not authorized to address every financial loss or to venture into the vast field of commercial paper.

The only thing that happened to these commercial notes was that they were fractionalized and distributed without marketing or solicitation. Here the notes were not marketed at all. There were no sales materials, no sales program, no solicitations, there was only word of mouth from other investors. There is no government interest in regulating non-marketed fractional commercial notes and as *Bromberg, supra* notes; "One of the most important elements in determining whether or not a particular instrument is a security...is the manner in which it is

marketed. *Bromberg, supra* at 4-94.6. *International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America v. Daniel*, 439 U.S. 551 (1979) and *Marine Bank v. Weaver*, 455 U.S. 551 (1982) had no marketing and in both cases the court found no security.

AMFAC, supra says that when the notes left Mortgages Ltd. they were not securities. Nothing happened after that—no marketing, no management of Mortgages Ltd. by Defendants, no change from an interest only instrument—to change the status of these notes from commercial notes. Just dividing them up does not make each fractional interest a security beyond all questions of fact. *See, AMFAC, supra.*

B. Radical Bunny Held An Enforceable Security Interest.

Equitable liens and equitable mortgages have been recognized in Arizona since at least 1908. *See Richardson v. Wren*, 11 Ariz. 395, 95 Pac. 124 (1908). The basic law is simple. "[W]here it is clearly shown that the intention of the parties to a transaction is to give a security for a debt or obligation upon some particular property, however informally such intention may be expressed, equity will...declare an equity mortgage or lien to exist...*Stephen v. Patterson*, 21 Ariz. 308, 311, 188 Pac. 131 (1920). The fact that none of the statutes are followed does not invalidate the lien. *Hueg v. Sunburst Farms (Glendale) Mut. Water and Agric. Co.*, 122 Ariz. 284, 594 P.2d 538 (App. 1979); and *see Kalmanoff v. Weitz*, 8 Ariz. App. 171, 444 P.2d 728 (1968).

While Scott Coles was alive, everyone at Mortgages Ltd. said Radical Bunny was secured by all the assets of Mortgages Ltd. Mortgages Ltd. prepared the documents evidencing that promise and repeatedly affirmed it. Any good lawyer would want to correct the absence of a formal security agreement, but that does not mean that as a matter of law no security exists. Even Mr. Bornhoft, the lawyer who wrote a letter to Mr. Kant saying Radical Bunny was unsecured,

admitted he had no opinion about whether it had equitable lien rights. *(Bornhoft at pp. 546, 640-641).*

If it did, then the only universal statement cited by the Division as a basis for its case is not an incorrect statement. "Your investment is collateralized by the beneficial interest under various deeds of trust held by Mortgages Ltd." was true. Mortgages Ltd. held deeds of trust and Radical Bunny was secured by everything Mortgages Ltd. owned. Everyone agreed to that and the financing statements by Mortgages Ltd. for recording said that. The subject of the lien was variously described in the financing statements as "all assets owned by Mortgages Ltd. from time to time" and "all mortgage interest under mortgages or beneficial interests under deeds of trust held by Mortgages Ltd." Radical Bunny could have foreclosed on its lien and owned those beneficial interests which it then also could have caused to be foreclosed. That is why Radical Bunny's Bankruptcy lawyer, Mr. Kroop, on cross examination acknowledged that the outcome of the Bankruptcy was that Radical Bunny was treated as fully secured and that it obtained all the relief it ever could have obtained with perfect documents. (*Kroop at pp. 2096, 2103*).

C. No Fraud Occurred When Representatives Said That Radical Bunny Was Secured.

The issue of whether questions that then existed about the adequacy of the documents can create an issue of misrepresentation for which Defendants can be held accountable depends on the extent each had a duty to disclose. *See Basic Inc. v. Levinson*, 485 U.S. 224, 239 n. 17, 108 S. Ct. 978, 99 L. Ed. 2d 194 (1988) ("Silence, absent a duty to disclose is not misleading under Rule 10b-5."). "When an allegation of fraud [under § 10(b)] is based on non-disclosure, there can be no fraud absent a duty to speak." *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 174, 114 S. Ct. 1439, 128 L.Ed. 2d 119 (1994) (quoting *Chiarella v. United States*, 445 U.S. 222, 232, 100 S. Ct. 1108, 63 L. Ed.

2d 348 (1980)). *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1545 (9th Cir. 1994). "And while "literally true," statements can give rise to liability under certain circumstances, "*Rule* 10b-5...prohibit[s] only misleading and untrue statements, not statements that are incomplete." These Defendants had no duty to affirmatively disclose activities designed to change their equitable lien to a statutory lien. The basis for the lien did not change the ultimate effect of the lien Radical Bunny has been determined to hold.

This is not the same case as the one pending in Federal Court where these Defendants are accused of aiding and abetting Mortgages Ltd.'s fraudulent conduct. Respondents deny anything like that occurred, but that is not the claim made by the Division. Rulings on motions to dismiss in the Federal cases are only based on what some plaintiff claims, not a determination of what happened. Finally, denials of motions to dismiss or motions for summary judgment are not final and cannot be used to decide cases in other litigation. *See Circle K Corp.* v. *Industrial Comm.*, 179 Ariz, 422, 980 P.2d 642 (App. 1993), *J.W. Hancock Ent.* V. *Arizona Reg. of Contrs.*, 142 Ariz. 400, 690 P.2d 119 (App. 1984), *Armstrong* v. *Aramco Services Co.*, 155 Ariz. 345, 746 P.2d 917 (App. 1987).

In this respect, *In Re Donald J. Trump Casinos Securities Litigation*, 7 F.3d 357, 370-71 (3rd Cir. 1993) is instructive. There, the Third Circuit Court of Appeals recognized that when "forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the 'total mix' of information...In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law." Respondents are entitled to protection under the "bespeaks caution" doctrine, because the alleged false statements contained in the Official Statements were "accompanied by meaningful cautionary statements." *In re Worlds of Wonder*, 35

F.3d at 1413. The clear evidence is that even when pressed participants and those who inquired were told "there are no guarantees."

See Teamsters Local 175, et.al. v. Clorox Co., et.al., 353 F.3d 1125, 1131-33 (9th Cir. 2004) (forward statements were accompanied by meaningful cautionary language); *In re Copper Mountain Sec. Litig.*, 311 F. Supp.2d 857, 882 (N.D. Cal. 2004) (cautionary statements need not identify "*all* factors that might make the results different from those forecasted." This doctrine was also recognized in *In re Worlds of Wonder Securities Litigation*, 35 F.3d 1407, 1413 (9th Cir. 1994). *See also In re Convergent Technologies, Inc.*, 948 F.2d 507, 516 (9th Cir. 1991). What might happen if Mortgages Ltd. defaulted is a "what if" future event. Under Arizona law, a claim for "negligent misrepresentation" or fraud cannot be predicated on statements regarding future occurrences. *McAlister v. Citibank*, 171 Ariz. 207, 215, 829 P.2d 1253, 1261 (Ct. App. 1992) (dismissing negligent misrepresentation claim because "allegations relating to McAlister's negligent misrepresentation claim all relate to future events."). Given the cautionary language routinely given, "there are no guarantees," Berta Walder Exhibit S-14 at 44:27, claims of problems with the documents establishing Radical Bunny's secured position are not actionable, particularly where, as here, Radical Bunny was ultimately determined to be secured.

D. The Commission Should Make Its Own Judgment Without Reference To What Some Self Interested Lawyer Said About The Application Of The Securities Laws.

Here the Division elicited testimony from self interested witnesses that they thought the participations were subject to the Securities Statutes. Of course not one of them wrote a letter or even sent a scrap of paper to Radical Bunny to that effect at the time and the only lawyer hired to research it wrote a letter saying he would look into it, then never provided a formal determination despite tens of thousands of dollars of legal fees. Their testimony cannot be considered.

The five factor test to determine whether to allow witnesses to testify to their conclusions mandated by *Daubert v. Merrill Dow Pharmaceuticals*, Inc., 509 U.S. 579 (1993) cannot apply to a legal opinion rather than a factual opinion for good reason. "If the expert is called simply to give an opinion on the applicable law, he should be excluded as introducing on the Judge's role. USCA, Commentary, Federal Rules of Evidence, Rule 701-end at p.70, citing *CMI Trading, Inc. v. Quantum Air, Inc.*, 98 F.3d 887 (6th Cir. 1996) where a witness wanted to testify that the parties had created a joint venture.

Legal conclusions have no place in an expert testimony "...[A]n expert witness cannot give an opinion as to her legal conclusion, i.e., an opinion on an ultimate issue of law." *Hangarter v. Provident Life and Acc. Ins. Co.*, 373 F.3d 998, 1016 (9th Cir. 2004); *see Nationwide Transp. Fin. V. Cass Info. Sys.*, 523 F.3d 1051 (9th Cir. 2008) where an expert on the Uniform Commercial Code was not allowed to testify. The Arizona law, when a case is not being tried to a jury, is the same. *Pool v. Superior Ct.*, 139 Ariz. 98, 677 P.2d 261 (1984), *Pincock v. Dupnik*, 146 Ariz. 91, 703 P.2d 1240 (App. 1985), *Webb v. Omni Block, Inc.*, 216 Ariz. 349, 166 P.3d 140 (App. 2007). It is up to the Commission, at this level, whether it wants to attempt the expansion of its jurisdiction into the transfer and fractionalization of commercial loans.

E. Howard Walder Has No Liability

We would be remiss if we did not point out that Howard Walder only ran the computer and accounting side of the Horizon and Radical Bunny operation. He did that without a single reported error. It was not his function to even talk to investors. He did not prepare the confirmation of purchase or the letters that went out. He did not manage either of the LLC's. He should be dismissed from this proceeding.

Conclusion

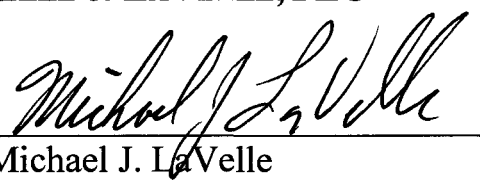
The participants' losses, if any, are beyond the powers of this Commission. Claims of fraud based on generalized non-factual words such as "safe" will not lie. Claims based on what might happen in the future will not lie. And claims that the investment was described as secured turned out to be true.

The participations were participations in ordinary commercial notes which have long been held to be not subject to the securities statutes.

This case should be dismissed.

RESPECTFULLY SUBMITTED this 4th day of April, 2011.

LAVELLE & LAVELLE, PLC

By: 

Michael J. LaVelle
2525 East Camelback Road, Suite 888
Phoenix, Arizona 85016
Attorneys for Respondents Tom Hirsch, Diane Rose Hirsch, Berta Walder, Howard Walder, Harish P. Shah, Madhavi H. Shah and Horizon Partners, LLC

ORIGINAL and 13 COPIES filed this
4th day of April, 2011 with:

ARIZONA CORPORATION COMMISSION
Securities Division
1300 West Washington, Third Floor
Phoenix, Arizona 85007

COPY of the foregoing MAILED this
4th day of April, 2011 to:

Lyn Farmer
Chief Administrative Law Judge
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007

COPY of the foregoing MAILED and EMAILED this
4th day of April, 2011 to:

Julie Coleman
ARIZONA CORPORATION COMMISSION
Securities Division
1300 West Washington, Third Floor
Phoenix, Arizona 85007